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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 210

P. G. LAKE, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH
CIRCUIT*

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 14-21) are reported in 4 T. C. 1. The opinion of the Circuit Court of Appeals (R. 62-66) is reported in 148 F. 2d 898.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 17, 1945 (R. 66). The petition for a writ of certiorari was filed on July 9, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Was interest payable to the taxpayer's principal stockholder, which was accrued by the taxpayer in 1939, deductible under Section 23 (b) of the Internal Revenue Code as constructively received and constructively paid, or was the deduction prohibited by the provisions of Section 24 (c) because not paid within two and one-half months after the close of the taxable year 1939?

2. Does the phrase "within the taxable year or within two and one-half months after the close thereof", contained in Section 24 (c) (1), refer to the year of accrual or the year in which the interest became due and payable?

3. Alternatively, were advances made to the principal stockholder within two and one-half months after the close of the taxable year 1939, which were carried in a separate account and were not offset against the interest account, deductible as interest paid?

STATUTE INVOLVED

The applicable provisions of the statute involved are set out in the Appendix, *infra*, pp. 15-16.

STATEMENT

The facts as found by the Tax Court (R. 15-17) may be summarized as follows:

The taxpayer, P. G. Lake, Inc., is a corporation chartered under the laws of Delaware and engaged in the business of oil production at Tyler,

Texas. The return for the taxable year 1939 was filed on the calendar year accrual basis. (R. 15.)

P. G. Lake, president and one of the directors of the taxpayer, and actively in charge, owned 60 per cent of its stock. The balance was owned by his children or by trusts created by Lake for the benefit of his children. Lake kept his books and made his returns on the calendar year cash receipts and disbursements basis. (R. 15.)

In 1936 the taxpayer became indebted to Lake in the amount of \$1,950,000 on account of a purchase of stock from him. This indebtedness was evidenced by 20 notes. One in the amount of \$50,000 became due and was paid in 1936. The remaining notes, each in the principal sum of \$100,000, were payable serially on January 1 of each year thereafter for 19 consecutive years, beginning January 1, 1937. Each of the notes bore interest at the rate of three and one-half per cent per annum, payable on January 1 of each year. (R. 15-16.)

The taxpayer accrued the interest monthly, crediting a ledger account designated "accrued interest payable" with the amount of the accrual the first day of each month. The amounts credited to this account represented only interest accrued upon the indebtedness owing Lake, and the taxpayer did not accrue interest in favor of any other creditor. (R. 16.)

On December 31, 1939, the accrued interest payable account showed a credit balance of \$55,-

844.45. On May 17, 1940, the taxpayer paid Lake by check the amount of \$156,000, representing principal in the amount of \$100,000 and interest of \$56,000. The interest was composed of \$55,844.45 accrued to December 31, 1939, plus \$155.55 accrued on January 1, 1940. No entry prior to May 17, 1940, reflecting payment of this amount of interest was made on the taxpayer's books. Interest in the amount of \$165.31 on account of one day, January 1, 1939, had previously been paid on November 2, 1939, and was concededly a proper deduction. (R. 16, 17.)

In its return for the year 1939 the taxpayer deducted interest in the amount of \$56,009.76, consisting of \$55,844.45 shown as a credit balance in the accrued interest payable account as of the close of the year and \$165.31 paid on November 2, 1939. Lake and his wife filed tax returns for the year 1940 on the community property basis, together reporting as income the item of \$56,000 interest. (R. 16.)

Since commencing operations, the taxpayer had maintained an open account receivable carried in Lake's name, representing loans to Lake for personal reasons. The account was settled periodically, but at irregular intervals, by Lake's payment of the amount owing. On January 1, 1940, this account showed a balance due from Lake of \$670.36. On March 15, 1940, the balance was \$32,226.89. By the end of April 1940, the balance amounted to \$55,762.09, and on May 17,

1940, Lake issued his check to the taxpayer in the amount of \$55,815.20, discharging the then existing balance. The accrued interest payable account and the personal account in the name of Lake were kept separately and the balances were never offset against each other. (R. 16-17.)

As president of the taxpayer, Lake was authorized to draw checks on its bank account and disburse funds for any proper purpose. No countersignatures were required. On January 1, 1940, the taxpayer had on deposit a cash balance of \$346,348.16. The lowest cash balance between that date and May 17, 1940, was \$306,548.05. Except for the indebtedness due Lake, there were no commitments against this balance. (R. 17.)

The Commissioner disallowed the deduction of interest in the amount of \$56,009.76, "in accordance with the provisions of section 24 (c) of the Internal Revenue Code" but later conceded before the Tax Court that the amount of \$165.31 representing interest for one day, January 1, 1939, and paid on November 2, 1939, was properly deductible. The amount of interest in controversy is \$55,844.45, representing interest accrued from January 2, 1939, to December 31, 1939. (R. 17.)

The Tax Court sustained the determination of the Commissioner to the extent of the disallowance of \$55,844.45 of the interest deduction claimed (R. 21). The Circuit Court of Appeals for the Fifth Circuit affirmed (R. 66).

ARGUMENT

1. There is no direct conflict, as alleged by the taxpayer (Pet. 7-11), between the decision in the instant case and that of the Circuit Court of Appeals for the Sixth Circuit in *Musselman Hub-Brake Co. v. Commissioner*, 139 F. 2d 65. It is true that the court below held that the word "paid", as used in Section 24 (c) (1), of the Internal Revenue Code (Appendix, *infra*, p. 15), referred only to a liquidation of a liability in cash. In the *Musselman* case, the Sixth Circuit held that "paid" included a satisfaction of the debt by the issuance of notes within the prescribed period, where the notes had a ready realizable market value equal to par value at the time of their receipt and the recipient had reported their value as income for the year in which received. But this case presents no such situation. No notes were given and no payment of interest was made until May 17, 1940, beyond the period prescribed in Section 24 (c) (1). Thus the facts in the instant case fall clearly within the language of the court in the *Musselman* case (139 F. 2d at 69) of a "mere accrual" of interest on the taxpayer's books and not a payment of interest. For reasons indicated by the argument in subdivision 3, *infra*, pp. 9-13, we think the *Musselman* decision was wrong, but we do not find such a direct conflict as to warrant further review by this Court.

2. The taxpayer (Pet. 11-16) urges that an important question of federal law is involved which should be settled by this Court, namely, whether the term "paid," as used in Section 24 (c) (1), includes constructive payment. The taxpayer asserts (Pet. 13) that the Tax Court is committed to the proposition that constructive receipt satisfies the requirements of Section 24 (c) (2), and in some cases dealing with salaries has held that constructive receipt by the creditor equals payment under Section 24 (c) (1). In *Michael Flynn Manufacturing Co. v. Commissioner*, 3 T. C. 932, relied upon by the taxpayer, the attention of the Tax Court was directed to Section 24 (c) (2). (Appendix, *infra*, p. 16.) The question was whether an unpaid salary, credited to the account of a principal stockholder and subject to his withdrawal on demand, was includible in the gross income of a creditor for the taxable year of the debtor. The Tax Court, relying on the doctrine of constructive receipt, held that the salary was available to the creditor and had properly been reported as income. In the instant case, the amount sought to be deducted was not due and payable to Lake until after the close of the taxpayer's taxable year, 1939. Being on the cash basis, Lake could not have included any sum on account of interest paid in his income tax return for the year 1939, since it was not paid to him until the year 1940, and there is no theory on

which it could be held that it was constructively received by Lake in 1939. Nor did Lake report it as income in that year, but in 1940. While the Tax Court has not always been consistent in its various holdings under Section 24 (c) and in some cases has held that an amount includible in gross income of the recipient under Section 24 (c) (2) is to be considered as paid under Section 24 (c) (1), it is unnecessary to resolve any conflict in its decisions in this case, for under no theory of constructive receipt was there such a receipt here. The constructive receipt doctrine is based upon the fact that a person is free by his own action or inaction to reduce money to his control and possession. It must be unqualifiedly subject to his demand. That is not the case here. The unpaid interest until paid was subject to the control of the taxpayer and not Lake, the creditor. There can be no constructive receipt without an unconditional credit on the books of the debtor in favor of the creditor, and the interest in the instant case was not credited to Lake on the taxpayer's books, nor was it ordered to be paid to him in 1939 or within two and one-half months after the close of that taxable year, the period prescribed in Section 24 (c) (1). (R. 16, 19-20).

It should be noted, moreover, that in *Jenkins v. Bitgood*, 101 F. 2d 17, 19 (C. C. A. 2d), certiorari denied, 307 U. S. 636, it was specifically held that constructive receipt is not correlative with payment. In that case a note was held taxable as

income to the recipient on the constructive receipt theory without permitting a corresponding deduction for payment by the maker. Constructive payment is a fiction applied only under unusual circumstances. *Mass. Mutual Life Ins. Co. v. United States*, 288 U. S. 269, 273-274; *Keith v. Commissioner*, 139 F. 2d 596 (C. C. A. 2d). And the theory of constructive payment was rejected in *Sanford Corp. v. Commissioner*, 106 F. 2d 882 (C. C. A. 3d), affirming 38 B. T. A. 139, certiorari denied, 309 U. S. 659, and in *Fincher Motors, Inc. v. Commissioner*, 43 B. T. A. 673, 676, a case arising under this very statute.

3. Finally, we believe that the court below properly held that an amount is not paid within the meaning of Section 24 (c) (1) unless paid in cash. The taxpayer here is claiming a deduction for interest accrued under Section 23 (b) of the Internal Revenue Code (Appendix, *infra*, p. 15). Under the provisions of Section 24 (c) an accrued deduction for interest is not allowable (1) if not paid within two and one-half months after the close of the taxpayer's taxable year; (2) if the amount is not includible in the creditor's gross income for the taxable year in which or with which the taxable year of the taxpayer ends; and (3) if, at the close of the taxpayer's taxable year or at any time within two and one-half months thereafter, both the taxpayer and the creditor are persons between whom losses would

be disallowed under Section 24 (b) (1) (Appendix, *infra*, p. 15). Admittedly the requirements of subparagraphs (2) and (3) of Section 24 (c) have been met under the facts of the instant case. The only issue raised by the taxpayer is whether the interest was "paid" within two and one-half months after the close of the taxable year in which accrued by the taxpayer as required by Section 24 (c) (1).

Congress has used the word "paid" in the literal sense. Cf. *Mass. Mutual Life Ins. Co. v. United States*, 288 U. S. 269, 270, 275. The ordinary and usual meaning of "paid" is to liquidate a liability in cash. *Helvering v. Price*, 309 U. S. 409, 413; *Eckert v. Burnet*, 283 U. S. 140, 141, 142; *United States v. Mitchell*, 271 U. S. 9, 12. A payment must deplete the assets of the debtor. In the instant case, the taxpayer did not liquidate its liability for the payment of interest until May 17, 1940, when Lake issued his check to the taxpayer discharging his indebtedness (R. 17) and the taxpayer paid Lake by check for the interest owed (R. 16). That was the date of payment and being more than two and one-half months after the close of the taxpayer's taxable year 1939, the payment fails to comply with the requirements of Section 24 (c) (1). Thus an allowance of the accrued deduction for interest "paid" is not allowable under Section 23 (b) of the Code. *Mansuss Realty Co. v. Commissioner*, 143 F. 2d 286 (C. C. A. 2d).

There is no resulting "harshness", as suggested by the taxpayer (Pet. 14), in literally construing the statute to mean actual payment, since by making payment within two and one-half months after the close of the taxable year the item of interest accrued in 1939 would be an allowable deduction if not prohibited by the other provisions of Section 24 (c). The taxpayer had ample unappropriated cash (R. 17) and it could have avoided the application of Section 24 (c) (1) by making payment prior to March 15, 1940. In any event, the plain obvious and rational meaning of the statute cannot be sacrificed even for the exigency of a hard case. *Deputy v. du Pont*, 308 U. S. 488, 498.

The taxpayer urges (Pet. 13) that the word "paid" includes constructive payment or constructive receipt by Lake of the interest due within the prescribed period. It is inconceivable that Congress used the words "paid * * * within two and one half months" after the close of the taxable year in any other sense than a liquidation of the indebtedness by actual payment within the period prescribed. The legislative history¹ shows that Congress was well aware that closely owned

¹ Section 24 (c) of the Internal Revenue Code was first enacted as Title III, Section 301 of the Revenue Act of 1937, c. 815, 50 Stat. 813, amending Section 24 (a) of the Revenue Act of 1936. See Report of the Joint Committee on Tax Evasion and Avoidance, H. Doc. No. 337, 75th Cong., 1st Sess., pp. 15-16, and H. Rep. No. 1546, 75th Cong., 1st Sess., p. 29 (1939-1 Cum. Bull. (Part 2) 704, 724-725).

corporations on the accrual basis were accruing items for expenses, salaries and other indebtedness which were deducted by the corporations but were not paid to or taken up as taxable income by creditors on the cash basis during the year of accrual. The result was that collection of the tax on items which a corporation had deducted was postponed and might never occur. Corporations were reaping the benefit of substantial deductions from income while the alleged recipients were postponing the payment of income taxes on the amount or indeed escaping tax on them altogether by choosing the year of receipt or postponing receipt indefinitely. It was to prohibit such practices, fast becoming common, that Section 24 (c) was enacted, and it was designed to compel actual payment within two and one-half months after the close of the taxable year in order to obtain a deduction for an accrued liability.

In view of the object to be accomplished, it would attribute an undue naïveté to the legislators to say that by use of the word "paid" they meant to leave open the loophole of "constructively paid". Where the definite word "paid" is used in a statute the courts may not engraft the word "constructively" thereon. Moreover, deductions from income are not a matter of right but of legislative grace and the taxpayer here does not bring its case squarely within the terms of the statute as written. *White v. United States*, 305 U. S. 281,

292; *Deputy v. du Pont*, 308 U. S. 488, 493; *New Colonial Co. v. Helvering*, 292 U. S. 435, 440.

The taxpayer's contention (Pet. 5) that the phrase "within the taxable year or within two and one half months after the close thereof", contained in Section 24 (c) (1), refers to the year in which the interest became due and payable (1940), and not the year of accrual of the interest by the taxpayer (1939), is untenable. *Mansuss Realty Co. v. Commissioner*, 143 F. 2d 286 (C. C. A. 2d). Section 24 (c) (1) deals with the accrual of a liability and its payment by a taxpayer, and not with the year when the obligation became due and payable. The interest which was accrued by the taxpayer and deducted in 1939 was properly accrued in that year. *Dixie Pine Co. v. Commissioner*, 320 U. S. 516, 519; *United States v. American Can Co.*, 280 U. S. 412, 419-420; *United States v. Anderson*, 269 U. S. 422. Congress therefore required payment of an accrued liability within two and one-half months after the close of the taxable year of the accrual taxpayer. This is the plain wording of the statute and its evident purpose.

4. The taxpayer alternatively contends (Pet. 2, 6) that advances in the sum of \$32,226.89, made by the taxpayer to Lake prior to March 15, 1940, should be considered as the payment of interest. The findings of the Tax Court (R. 16-17) support its holding (R. 20-21) that from the treatment of

the personal loan account by the parties it was not considered a payment on account of accrued interest. It was an entirely separate account and so kept. No offset against the interest account payable to Lake was entered as the advances were made or when Lake was paid the accrued interest. The two separate accounts, one for interest due (R. 46-51) and the other for loans or advances (R. 54-58), are set out in the record. The accounts were never commingled or offset. (R. 17, 20-21.)

CONCLUSION

The decisions below are correct and there is no warrant for further review by this Court. The petition should be denied.

Respectfully submitted.

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